[JOINT COMMITTEE PRINT]

# DESCRIPTION OF BILLS RELATING TO FOREIGN CONVENTION TAX RULES AND MISCELLANEOUS TAX BILLS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON SEPTEMBER 18, 1980

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PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

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# INTRODUCTION

This pamphlet provides a description of tax bills scheduled for a public hearing on September 18, 1980, by the Ways and Means Subcommittee on Select Revenue Measures.

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills (in the order listed in the hearing announcement), including a description of present law, issues involved, an explanation of the provisions of the bills, effective dates, and estimated revenue effects.

## I. SUMMARY

### 1. H.R. 7566—Messrs. Rostenkowski and Corman; H.R. 5180—Mr. Udall; and H.R. 5774—Mr. Downey

### Tax Treatment of Expenses in Attending Foreign Conventions

Under present law, a foreign convention is defined as any convention held outside the United States, its possessions, and the Trust Territory of the Pacific. Taxpayers may not deduct expenses of attending more than two foreign conventions per year. Where deductions are permitted, the amount of the deduction for transportation is limited to coach or economy airfare and the deduction for subsistence may not exceed the Federal per diem rate for the location where the convention is held.

In addition, no deduction is allowed unless certain requirements are met: a full day or half-day of business activities must be scheduled on each day during the convention; deductions for subsistence expenses are not allowed unless the individual attends two-thirds of the scheduled business activities; transportation costs are deductible in full only if at least one-half of the days are devoted to business related activities. The taxpayer is required to substantiate this attendance in accordance with detailed reporting requirements. Also, certain requirements are imposed upon the sponsoring organization or group.

*H.R. 7566.*—Under this bill, no deduction will be allowed for attending a foreign convention unless, taking certain factors into account, it is as reasonable for the convention to be held without the North American area as within it. The North American area would include the United States, its possessions, and the Trust Territory of the Pacific, Canada, Mexico, and Bermuda. The special limitations on subsistence expenses and transportation expenses and the special reporting requirements would be repealed.

*H.R. 5180.*—The bill would provide that conventions held within the North American area, rather than only in the United States and its possessions, would not be subject to the rules for deductibility of foreign convention expenses. For this purpose, the North American area would include Mexico, Canada, and the United States and its possessions.

*H.R. 5774.*—The bill would provide that conventions held within the North American area would not be subject to the foreign convention rules. The term North American area would be defined as the United States, its possessions, and the area lying west of the 30th meridian west of Greenwich, east of the International Date Line, and north of the Equator, but not including any country on the continent of South America.

### 2. H.R. 653—Messrs. Pickle and Hance; and H.R. 7715—Mr. Pickle

#### Estate and Gift Tax Exemption for State Judicial Plan Benefits

Under present law, the gross estate of an individual does not include the value of an annuity receivable by any beneficiary (other than the executor) under (1) a qualified pension, profit-sharing or stock bonus plan; (2) a qualified annuity plan; (3) tax-sheltered employee's annuity purchased by a charitable or educational organization; or (4) certain benefit plans for survivors of members of the armed services. In addition, any election by an individual that causes one of these annuities to become payable to a beneficiary upon the individual's death is not a transfer subject to the gift tax. In general, present law exempts only benefits payable under a funded plan.

The bills, H.R. 653 and H.R. 7715, would provide an exemption from estate and gift taxes for benefits and certain elections made with respect to benefits receivable under qualified State judicial plans which are unfunded. The bill H.R. 7715 would limit to $500,000 the amount of benefits from a qualified State judicial plan that would be exempt from estate and gift taxes.

### 3. H.R. 2162—Messrs. Conable and Rangel

#### Exemption from Debt-Financed Income Rules for Certain Real Estate Investments of Tax-Exempt Employees' Trusts

Generally, under present law, if an otherwise tax-exempt trust forming part of a qualified pension, profit sharing, or stock bonus plan ("qualified retirement plan") invests in debt-financed property, all or a portion of the income derived from such property is treated as unrelated to the exempt functions of the trust and therefore is subject to income tax as unrelated business taxable income.

The bill would prescribe qualification rules for a group real estate employee benefit trust in which at least ten or more qualified retirement plans maintained by ten or more employers participate. Subject to certain investment and other conditions, a group real estate employee benefit trust would be a tax qualified trust established to invest in real estate in the United States or Puerto Rico. Unlike other trusts forming part of qualified retirement plans, a group real estate employee benefit trust would not be subject to the tax on unrelated debt-financed income.

### 4. H.R. 4518—Mr. Vander Jagt

#### Tax Exemption for Industrial Development Bonds for Beverage Container Facilities

Under present law, tax-exempt industrial development bonds (IDBs) may be used to provide solid waste disposal facilities. The term "solid waste" is defined by Treasury regulations to mean garbage, refuse or other discarded materials which have no market or other value at the place they are located.

Refillable beverage containers do not, in general, qualify as solid waste. As a result, tax-exempt financing is generally not available for facilities used in the collection and processing of such containers.

The bill would allow tax-exempt IDBs to be used to finance the acquisition of beverage container facilities for use in a State or locality that has enacted a law which penalizes or prohibits the sale of beverages in nonreturnable bottles, or penalizes or prohibits the sale of beverages in metal containers with detachable opening devices. The facilities that may be financed under the bill are:

(1) refillable beverage containers and shells,

(2) property used in the collection, transportation, sorting, storage or handling of beverage containers;

(3) property used in the cleaning and processing of refillable beverage containers; and

(4) property used for the manufacture of metal beverage container tops with nondetachable opening devices.

### 5. H.R. 5760 and H.R. 5761—Mr. Edwards (of Alabama); et al.

### Amount of Deduction for Casualty Losses of Timber and Fruit or Nut Trees

Under present law, the deduction for a casualty loss is limited to the amount of the taxpayer's adjusted basis in the property which was destroyed or damaged.

H.R. 5760 provides that in the case of timber, the loss limitation would be the greater of the taxpayer's adjusted basis in the property or its fair market value before the casualty occurred. H.R. 5761 provides similar treatment for casualty losses of fruit or nut trees. Under each bill, a special loss carryback rule of ten taxable years and carryover period of four taxable years would apply to casualty losses of timber and of fruit and nut trees. The bills would apply to losses incurred after August 31, 1979.

### 6. H.R. 6442—Mr. Jones (Oklahoma)

### Gain on Sale of Stock of Foreign Investment Company

Under present law, gain from the sale of stock of a corporation which at any time is a foreign investment company generally is treated as ordinary income to the extent of the selling shareholder's portion of the corporation's earnings and profits. Under the bill, gain attributable to earnings and profits for the period before the corporation became a foreign investment company would not be subject to this ordinary income treatment.

### 7. H.R. 7170—Messrs. Whitten, Findley, Montgomery, Madigan, Bowen, and Moorhead (Pa.)

### Transitional Election of Estate Tax Special Valuation of Farm or Other Business Real Property

For estate tax purposes, real property must ordinarily be valued at its highest and best use. If certain requirements are met, however, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at current use value rather than full fair market value, provided that the gross estate may not be reduced more than $500,000 (Code sec. 2032A).

The election for special valuation must be made not later than the due date for the estate tax return (Code sec. 2032A(d)(1)). It is to be made in the manner as prescribed under Treasury regulations.

The bill provides a special rule for returns required to be filed before July 13, 1978. Under this special rule, an election could be made by an estate required to file before such date no later than the 90th day after the later of (1) the date of enactment of the bill or (2) the earliest date on which all section 2032A necessary regulations become final. In addition, the bill extends the statute of limitations to allow claims for refund to be made until 90 days after the end of this special election period.

### 8. H.R. 7390—Messrs. Conable, Frenzel, Edwards (of Alabama), Daniel B. Crane, and Andrews (N.D.); and H.R. 7704—Mr. Conable

### Deferred Application of Revenue Procedure 80–5 and Revenue Ruling 80–60 Relating to Inventory Writedowns

Revenue Procedure 80–5 and Revenue Ruling 80–60 require taxpayers to conform their method of inventory accounting to that method of inventory accounting approved by the Supreme Court in *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979). For taxpayers with excess inventories (inventories in excess of foreseeable demand) that have been erroneously written down for tax purposes, these pronouncements require that the writedowns be taken back into income.

The Internal Revenue Service pronouncements were issued on February 8, 1980, and are applicable to 1979 taxable years. Taxpayers contend that by waiting until 1980 to release the pronouncements, the IRS has prevented them from being able to comply in 1979 with certain Treasury regulations that would have mitigated the income recapture required under the *Thor Power* decision. These bills would delay the implementation of Revenue Procedure 80–5 and Revenue Ruling 80–60 to taxable years beginning after 1979 and would give taxpayers the opportunity to take mitigating action under the Treasury regulations.

### 9. H.R. 7504—Mr. Guarini

### Theatrical Production Investment Tax Credit Act of 1980

Under present law, taxpayers are entitled to receive an investment credit for certain tangible personal property that is placed in service by the taxpayer. The presentation of a dramatic work, such as a play or opera, before a live audience is not tangible personal property, and no investment credit is allowed for an investment in a theatrical production. The bill would allow an investment credit for qualified investments in certain theatrical productions.

### 10. H.R. 7556—Messrs. Conable, Rostenkowski, and Seiberling

### Adjustments in Excise Tax on Tires

Present law imposes an excise tax of 10 cents per pound on new highway tires (to be reduced to 5 cents per pound on October 1, 1984), and 5 cents per pound on new nonhighway tires. A credit or refund is allowed with respect to tires for which a warranty or guarantee adjustment is made. However, there are no specific statutory provisions as to the proper method of computing the credit or refund.

The bill would reduce the excise taxes on new tires by 2.5 percent, beginning on January 1, 1981, and disallow an excise tax credit or refund with respect to tires for which a warranty or guarantee adjustmeint is made after December 31, 1982. The bill also would provide a special rule for determining a credit or refund for tires which are adjusted after March 31, 1978, and prior to January 1, 1983. In this period, a credit or refund would be determined under the IRS administrative guidelines in effect on March 31, 1978.

### 11. H.R. 7618—Messrs. Shannon, Corman, and Smith (Iowa)

### Incentive Stock Options

Generally, under present law, an employee is taxed on a compensatory stock option at the time the option is received, or, if the option does not have a readily ascertainable fair market value, at the time it is exercised. The employer has a corresponding deduction as a business expense.

Under the bill, a stock option meeting certain requirements which is granted to an employee would be taxed at capital gains rates when the employee sells the stock. The employer would receive no deduction.

The bill would apply to options granted after the date of enactment.

### 12. H.R. 7766—Messrs. Corman and McKinney

### One-Year Extension of Fuels Tax Exemption for Certain Taxicabs

Under present law, certain taxicab use of motor fuels is exempt (via refund or credit) from the 4 cents a gallon excise tax on gasoline and other motor fuels. The fuel is exempt if certain ride sharing rules and motor vehicle fuel economy standards are met. The exemption applies for calendar years 1979 and 1980.

The bill would extend the present fuels tax exemption for qualified taxicab services for one year, or through December 31, 1981.

### 13. H.R. 8058—Messrs. Stark, Corman and Rousselot

### Accrual of Tax Deductions After Change in Liability Date

Under present law, if a taxing jurisdiction changes the assessment date for a deductible tax (e.g., a State or local property or income tax), an accrual basis taxpayer cannot accrue a deduction for that tax on the new assessment date because it would result in a deduction of two taxes in the year of change (i.e., the tax whose assessment date was not changed and the tax whose assessment date was changed). The taxpayer is required to continue to deduct the tax on the basis of the original assessment date.

The bill would allow the taxpayer to deduct the tax on the new assessment date for the year of change. However, for that same year the taxpayer could not deduct the tax whose assessment date had not changed. This would avoid the result of the taxpayer having two tax deductions in one year.

### 14. H.R. 8073—Mr. Ullman

### Tax Treatment of Certain Transactions Involving Automobiles or Trucks

In certain transactions involving an automobile or truck, the Internal Revenue Service has taken the position that, under present law, a lease agreement which contains a "rental adjustment clause" constitutes a sale rather than a lease for Federal income tax purposes.

The bill provides that the determination of whether a transaction is a sale or lease for Federal income tax purposes would be made without regard to any rental adjustment clause in the agreement, where such transaction is entered into before January 1, 1981, and under which a person acquires from another person the right to use an automobile or truck for a specified period.

# II. DESCRIPTION OF BILLS

## 1. H.R. 7566—Messrs. Rostenkowski and Corman; H.R. 5180—Mr. Udall; and H.R. 5774—Mr. Downey

## Tax Treatment of Expenses in Attending Foreign Conventions

### *Present law*

Present law provides specific rules (sec. 274(h)) limiting the amount otherwise deductible (under Code secs. 162 or 212) for expenses of attending conventions, seminars, or similar meetings held outside the United States, its possessions, and the Trust Teerritory of the Pacific. These rules apply not only to the individuals attending the convention, but also to an employer who pays the expenses. Under these rules:

(1) No deduction is allowed for expenses paid or incurred by an individual in attending more than two foreign conventions in any taxable year.

(2) With respect to the two conventions for which a deduction is allowable, the amount of expenses that can be deducted for transportation and subsistence are limited. A deduction for transportation expense outside the United States may not exceed the coach or economy rates charged by a commercial airline. The deduction for subsistence may not exceed the dollar per diem rate established for Federal employees at the location in which the convention is held.

(3) No deduction is allowed for subsistence expenses unless (a) a full day or half-day of business activities are scheduled on each day during the convention, and (b) the individual attends at least two-thirds of the hours of the daily scheduled business activities or, in the aggregate, attends at least two-thirds of the total hours of scheduled business activities at the convention.

(4) A deduction for the full amount of expenses of transportation (subject to the coach or economy rate limitation) to and from the site of a foreign convention is allowable only if one-half or more of the total days of the trip are devoted to business-related activities. In determining whether a day is devoted to business-related activities, the same rules for counting full days and half-days for purposes of subsistence expenses are applied.

(5) The taxpayer must comply with certain reporting requirements. For example, information must be furnished to indicate the total days of the trip (exclusive of the transportation days to and from the convention), the number of hours of each day devoted to business activities (in a brochure describing the convention, if available), and any other information required by regulations. In addition, the taxpayer must attach a statement to his income tax return, signed by an appro-

priate officer of the sponsoring organization, which must include a schedule of the business activities of each convention day, the number of hours that the taxpayer attended these activities each day, and any other information required by regulations.

### *Issues*

The issues include the following:

(1) Whether foreign convention expenses should be deductible only if it is as reasonable to hold the convention in a foreign location as in the United States (or the North American area).

(2) Whether the definition of a foreign convention should be changed to exclude Mexico, Canada, and Bermuda (or the Caribbean area) from limitation on deductibility of foreign convention expenses.

(3) Whether the special limitations on deductibility of subsistence and transportation expenses and special reporting requirements for a foreign convention should be repealed.

### *Explanation of the bill*

## *H.R. 5180*

The bill would redefine [1] the North American area to include Mexico and Canada and deleting the Trust Territory of the Pacific.

### *Effective date*

The amendments made by this bill would apply to conventions beginning after December 31, 1978.

### *Revenue effect*

It is estimated that enactment of this legislation would result in a revenue loss of less than $5 million annually.

## *H.R. 5774*

### *Explanation of the bill*

The bill would narrow the meaning of the term foreign convention so that it would only apply to any convention, seminar, or similar meeting held outside the North American area and the Trust Territory of the Pacific. The term North American area would be defined as the United States, its possessions, and the area lying west of the 30th meridian west of Greenwich, east of the International Date Line, and north of the Equator, but not including any country on the continent of South America.

### *Effective date*

The amendments made by this bill would apply to conventions beginning after December 31, 1978.

### *Revenue effect*

It is estimated that enactment of this legislation would result in a revenue loss of less than $5 million annually.

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[1] The bill amends section 274(b) of the Internal Revenue Code. It is presumed that the bill is to amend section 274(h).

**H.R. 7566**

## Explanation of the bill

*General test*

The bill would replace all of the rules and limitations of present law (i.e., the two-convention rule, the subsistence expense limitation, the coach fare limitation, and the special reporting requirements) with a reasonableness standard. Under the bill, no deduction is to be allowed for expenses allocable to a convention, seminar, or similar meeting held outside the North American area unless the taxpayer establishes that the meeting is directly related to the active conduct of a trade or business and, taking certain factors into account, it is "as reasonable" for the meeting to be held outside the North American area as within it.

Under the reasonableness standard, the factors to be taken into account are: (1) the purpose of the meeting and the activities taking place at the meeting; (2) the purposes and activities of the sponsoring organizations or groups; (3) the residences of the active members of the sponsoring organization and the places at which other meetings of the sponsoring organizations or groups have been or will be held and (4) such other relevant factors as the taxpayer may present.

The reasonableness requirement would not be satisfied for a convention, seminar, or similar meeting which is conducted on board a cruise ship.

In addition, the bill makes it clear that the foreign convention provisions do not apply to normal business meetings for employees of a company.

*Foreign convention—North American area*

Under the proposal, a convention would not be treated as a foreign convention unless it were held outside the United States, its possessions, and the Trust Territory of the Pacific, and Canada, Mexico and Bermuda.

*Subsistence expense limitation*

## Effective date

This bill would be effective with respect to foreign conventions beginning after December 31, 1981.

## Revenue effect

It is estimated that this bill would have a negligible revenue effect.

## 2. H.R. 653—Messrs. Pickle and Hance; and H.R. 7715—Mr. Pickle

## Estate and Gift Tax Exemption for State Judicial Plan Benefits

### *Present law*

Under present law, the gross estate of an individual does not include the value of an annuity receivable by any beneficiary (other than the executor) under (1) a qualified pension, profit-sharing or stock bonus plan; (2) a qualified annuity plan; (3) a tax-sheltered employee's annuity purchased by charitable or educational organization; or (4) certain benefit plans for survivors of members of the armed services (Code sec. 2039(c)). In addition, any election by an individual that causes one of these annuities to become payable to a beneficiary upon the individual's death is not a transfer subject to the gift tax (Code sec. 2517). There is no limit on the amount of benefits which may be exempt from estate and gift taxes under these provisions.

In general, present law exempts only benefits payable under a funded plan. There is an exception to this rule, however, for benefits receivable under the Federal retired serviceman's family protection plan, which is unfunded (Code secs. S. 2039(c)(4) and 2517(a)(4)).

### *Issue*

The issue presented by the bills is whether the exemptions provided in Code sections 2039(c) and 2517 should be expanded to include survivor benefits payable under certain State judicial plans which are not funded.

### *Explanation of the bill*

The bills, H.R. 653 and H.R. 7715, would provide an estate tax exclusion for annuities payable from a qualified State judicial plan. In addition, any election by a judge that causes payment upon his death to a beneficiary of an annuity under a qualified State judicial plan would not be subject to the gift tax. The bill H.R. 7715 would limit to $500,000 the amount of benefits from a qualified State judicial plan that would be exempt from estate and gift taxes.

A qualified State judicial plan means a plan of a State for the exclusive benefit of elected judges or their beneficiaries, under which the judges covered have no option with respect to participation in or contribution to the plan. The plan would have to be a defined benefit plan which meets the limitations on contributions and benefits applicable to qualified retirement plans. There is no requirement that the plan maintain a separate fund or award benefits or hold an annuity contract solely for the payment of benefits.

### *Effective date*

The bills would apply to estates of decedents dying after December 31, 1972. If the estate of an individual could claim a refund or credit of tax (as a result of the bill) but is prevented by any rule of law from doing so, the refund or credit would nevertheless be allowed if a claim is filed within one year after the date of enactment of the bill. The retroactive application of the provisions in the bills is intended to benefit of the estates of 15 individuals who were judges of the State of Texas.

### *Revenue estimate*

The revenue estimate for this bill is not yet available.

## 3. H.R. 2162—Messrs. Conable and Rangel

## Exemption From Debt-Financed Income Rules for Certain Real Estate Investments of Tax-Exempt Employees' Trusts

### *Present law*

Generally, any organization which is exempt from Federal income tax under Code section 501(a) is taxed only on income from trades and businesses which are unrelated to the organization's exempt purposes; it is not taxed on passive investment income or income from any trade or business which is related to the organization's exempt purposes.[1]

This system of taxation applies to tax-exempt pension, profit-sharing, and stock bonus trusts described in Code sec. 401(a) as well as most other tax-exempt organizations (described in the various paragraphs of Code sec. 501(c)).

Before 1969, some exempt organizations had used their tax-exempt status to acquire businesses through debt financing, with purchase money obligations to be repaid out of tax-exempt profits, for example, as from leasing the assets of acquired businesses to the businesses' former owners.

The Tax Reform Act of 1969 provided (in the so-called "Clay Brown provision") that an exempt organization's income from "debt-financed property," which is not used for its exempt function, is to be subject to tax in the proportion in which the property is financed by debt (Code secs. 512(b)(4) and 514). In general, debt-financed property is defined as any property which is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year or during the 12 months prior to disposition if the property is disposed of during the taxable year (Code sec. 514(b)(1)). A debt constitutes acquisition indebtedness with respect to property if the debt was incurred in acquiring or improving the property, or if the debt would not have been incurred "but for" the acquisition or improvement of the property.[2]

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[1] There are some exceptions to the general rule that passive investment income is tax exempt. For example, social clubs (Code sec. 501(c)(7)) and voluntary employees beneficiary associations (Code sec. 501(c)(9)) are generally taxed on such income. Also, private foundations are subject to an excise tax of 2 percent on their net investment income.

[2] There are several exceptions from the term "acquisition indebtedness." For instance, one exception is indebtedness on property which an exempt organization receives by devise, bequest, or under certain conditions, by gift. Also, the term "acquisition indebtedness" does not include indebtedness which was necessarily incurred in the performance or exercise of the purpose or function constituting the basis of the organization's exemption. Special exceptions are also provided for the sale of annuities and debts insured by the Federal Housing Administration to finance low- and moderate-income housing.

### *Issue*

The issue is whether qualified retirement plans should be able to jointly participate in a group real estate employee benefit trust and not be subject to the tax on unrelated debt-financed income.

### *Explanation of the bill*

The bill would extend tax-exempt treatment to a group real estate employee benefit trust. In general, a qualified trust would be one established by ten or more qualified retirement plans maintained by ten or more employers to invest primarily in real estate located in the United States or Puerto Rico.

The qualified status of a participating trust would not be affected by participation in the group real estate employee trust if the adjusted cost of its interest in a group real estate employee benefit trust was less than 25 percent of the aggregate adjusted cost of its assets at the end of each quarter of its plan year.

If a trust qualified as a group real estate employee benefit trust, it generally would be exempt from tax like a trust under a qualified retirement plan. However, unlike a trust under a qualified retirement plan, a group real estate employee benefit trust would be exempt under most circumstances from the tax on unrelated debt-financed income.

To qualify as a group real estate employee benefit trust, the trust would have to be established and maintained in the United States and at all times during its taxable year would have to meet the following requirements: (1) the aggregate adjusted cost of the real property located in the United States and Puerto Rico held by a trust would have to exceed $10 million; (2) at least 75 percent of the adjusted cost of the trust's property would have to be real property located in the United States or Puerto Rico, cash or Government securities; (3) no qualified retirement plan participating in the trust could have more than a 50 percent interest in the trust; (4) the trust would not be permitted to lease real property to a person from whom it acquired such property; (5) the trust could not own land used in farming; and (6) all of the real property owned by a trust would have to be managed by an investment manager.

In addition, the instrument governing a real estate employee benefit trust would have to provide that (1) the assets of the trust could not be commingled with other property; (2) only qualified retirement plans could participate in the trust; (3) the portion of the trust which equitably belongs to a qualified retirement plan would be used for the exclusive benefit of that plan's participants and beneficiaries; (4) the income and corpus of the trust would be allocated according to a participating plan's interest and (5) a participating plan could not assign its interest in the trust.

### *Effective date*

The provisions of the bill would be effective on January 1, 1980.

### *Revenue effect*

It is estimated that this bill will reduce budget receipts by relatively small amounts during the next few years, probably less than $10 million annually. Eventually, it could have significant revenue effect.

## 4. H.R. 4518—Mr. Vander Jagt

### Tax Exemption for Industrial Development Bonds for Beverage Container Facilities

#### *Present law*

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for interest on IDBs applies in the case of IDBs which are used to provide solid waste disposal facilities. Solid waste disposal facilities are defined in Treasury regulations as property used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste. A facility which disposes of solid waste by reconstituting, converting, or otherwise recycling it into material which is not solid waste will qualify as a solid waste disposal facility if 65 percent of the material introduced into the recycling process is solid waste (Treas. Reg. sec. 1.103–(f)(2)(ii)).

The Internal Revenue Code does not define the term "solid waste." However, the legislative history of the IDB exception for solid waste disposal facilities indicates that the term has the same meaning as it had in the Solid Waste Disposal Act. In that Act, solid waste was defined as "garbage, refuse, and other discarded solid materials." The legislative history of that Act states that "solid wastes include a great variety of things that individuals, manufacturers, commercial establishments, and communities discard as no longer useable."

The Treasury Regulations, which define the term "solid waste", provide that solid waste means garbage, refuse, and other discarded materials so long as it is property which is useless, unused, unwanted, or discarded solid material which has no market or other value at the place it is located (Treas. Reg. sec. 1.103–8(f)(2)(ii)).

As a result of the existing definition of the term "solid waste", facilities used in connection with returnable beverage containers will not, in general, qualify as solid waste disposal facilities.

#### *Issue*

The issue is whether tax-exempt IDBs should be allowed to be used to finance the acquisition of refillable beverage containers and shells, property used in the collection, transportation, sorting, storage, or handling of beverage containers, property used in the cleaning and processing of refillable beverage containers, and property used for the manufacture of metal beverage container tops with nondetachable openings, in States or localities which prohibit or discourage the use of nonreturnable bottles or metal containers without nondetachable opening devices.

### *Explanation of the bill*

The bill provides that interest on IDBs would be exempt from Federal income taxation where the proceeds of the bonds are used to acquire—

(1) facilities used in the collection, transportation, sorting, handling, or storage of beverage containers,

(2) facilities used in the cleansing and processing of refillable beverage containers, or

(3) refillable beverage containers and shells,

if such facilities are acquired and used in connection with a beverage container law that requires a deposit on beverage containers or penalizes or prohibits the use of nonreturnable beverage containers.[1]

In addition, the bill would permit the issuance of tax-exempt IDBs where the proceeds of the bonds are used to acquire facilities for the manufacture of metal beverage container tops with nondetachable openings, if such facilities are acquired and used in connection with a beverage container law that penalizes or prohibits the sale of metal beverage containers with detachable openings.

### *Effective date*

The bill would be effective for obligations issued after December 31, 1978.

### *Revenue effect*

It is estimated that this bill will reduce budget receipts by $10 million in fiscal year 1981, $20 million in 1982, $40 million in 1983, $60 million in 1984, and $70 million in 1985.

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[1] The bill apparently contains a drafting error which would apply the requirement that the facilities be acquired in connection with a beverage container law only to the third category set forth above.

## 5. H.R. 5760 and H.R. 5761—Mr. Edwards (of Alabama), et al.

### Amount of Casualty Loss Deduction for Timber and Fruit or Nut Trees

#### *Present law*

*In general*

Under present law, a corporation may deduct the amount of property losses sustained during the taxable year which are not insured or otherwise recoverable (Code sec. 165). An individual may deduct the amount of an unrecoverable loss incurred in a trade or business, in a transaction entered into for profit, or (subject to a $100 floor per occurrence) as a casualty or theft loss (sec. 165(c)).

In the case of partial loss caused by casualty, the amount of the loss equals the difference between the value of the property immediately preceding the casualty and its value immediately thereafter (Treas. Reg. § 1.165–7(b)). However, the deduction cannot exceed the property's adjusted basis (sec. 165(b)). If business or income-producing property is completely destroyed, the amount deductible is the adjusted basis of the property (Treas. Reg. § 1.165–7(b)).

*Computation of adjusted basis*

In computing the adjusted basis of property damaged or destroyed by casualty, the taxpayer's cost or other basis is adjusted for capitalized expenditures which become part of the basis, and for deductions for such items as depreciation, amortization, and depletion, which reduce the taxpayer's basis in the property.[1]

In the case of timber property, adjusted basis includes the cost of purchasing a stand of timber (other than any part of the cost allocable to land), and also capitalized costs (such as those for site preparation and planting costs) in connection with the planting or seeding of trees for timber purposes. In the case of fruit and nut trees, special capitalization rules apply with respect to expenditures incurred in planting and developing citrus and almond groves and, in the case of certain farming syndicates, with respect to expenditures incurred in planting and developing a grove, orchard, or vineyard in which fruit or nuts are grown (sec. 278). In addition, several special deduction allowance rules may affect the determination of adjusted basis of timber and fruit and nut trees, i.e., deductions for soil and water conservation expenditures (sec. 175), expenditures by farmers for fertilizer (sec. 180), and expenditures by farmers for clearing land (sec. 182).

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[1] Depletion of timber is limited to cost depletion and is claimed at the time the timber is harvested (Regs. § 1.611–1). In addition, a taxpayer may elect capital gain treatment for income recognized from the cutting of timber (Code sec. 631(a)).

*Net operating loss deduction*

Present law also treats casualty losses as trade or business losses for purposes of computing a net operating loss deduction. Accordingly, a net operating loss which is created as a result of a casualty loss may generally be carried back as a deduction against income for the three taxable years preceding the taxable year in which the loss occurred and may be carried over as a deduction against income for the seven taxable years following the year of the loss (Code secs. 172 (b) and (d); Treas. Reg. § 1.172–3(a)(3)(iii)).

In addition, where a casualty loss is attributable to a disaster in an area which is proclaimed by the President to be a disaster area eligible for federal assistance, the taxpayer may elect to treat the loss as having occurred in the immediately preceding taxable year and the loss may be deducted for this earlier year (Code sec. 165(h)).

## *Issues*

*H.R. 5760*

The issues with respect to H.R. 5760 are (1) whether a taxpayer suffering an otherwise deductible loss of timber may deduct the fair market value of the timber immediately before the loss, even if such value exceeds the adjusted basis of the timber; and (2) if so, whether any unused amount of the deduction may be carried back ten years and forward four years.

*H.R. 5761*

The issues with respect to H.R. 5761 are (1) whether a taxpayer suffering an otherwise deductible loss of a fruit or nut tree may deduct the fair market value of the tree at the time of the loss, even if such value exceeds the adjusted basis of the tree; and (2) if so, whether any unused amount of the deduction may be carried back ten years and forward four years.

## *Explanation of the bills*

*H.R. 5760—Timber*

The bill, H.R. 5760, would provide that the amount of deductible loss arising from a casualty loss of timber which is completely destroyed is the fair market value of the timber immediately before the casualty. In the case of a partial loss, the initial determination of the amount of loss would be made as under present law by reference to the decline in value resulting from the casualty. However, under the bill, the basis limitation on the amount of the deductible loss would be applied by using the higher of the property's adjusted basis or its fair market value on the date the loss occurs.

In addition, the bill would treat casualty losses from timber as a separate category of deduction which would be deducted in computing taxable income after other allowable deductions authorized by the Internal Revenue Code. To the extent this deduction creates a loss in the year of the casualty, the excess deduction would be allowed to be carried back to the ten preceding taxable years and carried over to the four taxable years following the year of the casualty.[2]

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[2] The effective carryback and carryover periods would be 11 years and 3 years, respectively, if the loss qualifies as a disaster loss and the taxpayer makes the election provided under Code section 165(h).

*H.R. 5761—Fruit and nut trees*

The bill, H.R. 5761, would provide that a taxpayer suffering a loss in a trade or business with respect to fruit or nut trees which are completely destroyed and for which a depreciation deduction is allowable (determined without regard to the age of the trees or their productivity over their useful life) may deduct the higher of the property's adjusted basis or its fair market value on the date the loss occurs. In the case of a partial loss, the initial determination of the amount of loss would be made as under present law by reference to the decline in value resulting from the casualty. However, under the bill, the basis limitation on the amount of the deductible loss would be applied by using the higher of the property's adjusted basis or its fair market value on the date the loss occurs.

Also, the bill would provide that in the case of an individual, any unused fruit or nut tree loss deduction could be carried back ten years and, if not offset by income of such prior years, forward for four years.

### *Effective date*

*H.R. 5760*

The provisions of H.R. 5760 would be effective for qualifying timber losses which are incurred after August 31, 1979.

*H.R. 5761*

The provisions of H.R. 5761 would apply to fruit or nut tree losses incurred after August 31, 1979.

### *Revenue effect*

*H.R. 5760*

It is estimated that this bill will reduce budget receipts by $476 million in fiscal year 1981 (which includes liability from previous years), $274 million in 1982, $306 million in 1983, $339 million in 1984, and $374 million in 1985.

*H.R. 5761*

It is estimated that this bill will reduce budget receipts by $23 million in fiscal year 1981 (which includes liability from previous years), $17 million in 1982, $18 million in 1983, $20 million in 1984, and $22 million in 1985.

## 6. H.R. 6442—Mr. Jones (of Oklahoma)

### Gain on Sale of Stock of Foreign Investment Company

***Present law***

In general, gain on the sale of stock in a foreign corporation which is a foreign investment company is treated as ordinary income to the extent of the selling shareholder's portion of its earnings and profits. A foreign investment company is defined as any foreign corporation controlled by U.S. persons which is registered under the Investment Company Act of 1940 or which engages in certain investment activities specified in that Act

Ordinary income treatment applies to the extent of the earnings and profits attributable to the period of time (after 1962) during which the stock was held by the selling shareholder (even if the corporation was a foreign investment company for only part of that period). Thus, for example, the U.S. shareholders of a foreign corporation which was organized in 1963, which engaged in activities which made it a foreign investment company for only one year, say, 1970, and which liquidated in 1980, would be taxed under section 1246 as though the corporation were a foreign investment company for the entire 17 years rather than just the one year.

***Issue***

The issue is whether gain from the sale of stock in a foreign corporation attributable to earnings and profits from the period before the corporation became a foreign investment company should be treated as ordinary income.

***Explanation of the bill***

The bill would provide that gain on the sale of a foreign corporation's stock will not be taxed under Code section 1246 with respect to earnings and profits of the corporation attributable to years before the corporation is a foreign investment company. This treatment would prevent gain attributable to active business operations from being taxed under the foreign investment company provisions if the corporation subsequently becomes a foreign investment company. In most cases, this would result in treatment of the gain as capital gain. However, if the corporation has been a controlled foreign corporation, part of the gain might be treated as a dividend (Code sec. 1248).

***Effective date***

The bill would apply to sales or exchanges after the date of enactment of the bill in taxable years ending after that date.

***Revenue effect***

It is estimated that this bill would reduce budget receipts by $5 million in fiscal year 1981 and by less than $1 million annually in later years.

## 7. H.R. 7170—Messrs. Whitten, Findley, Montgomery, Madigan, Bowen, and Moorhead (Pennsylvania)

## Transitional Election of Estate Tax Special Valuation of Farm or Other Business Real Property

### *Present law and background*

*In general*

For estate tax purposes, real property must ordinarily be valued at its highest and best use. If certain requirements are met, however, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at current use value rather than full fair market value, provided that the gross estate may not be reduced more than $500,000 (Code sec. 2032A).

*Qualification requirements*

To qualify for current use valuation: (1) the decedent must have been a citizen or resident of the United States at his death; (2) the value of the farm or closely held business assets in the decendent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property), must be at least 50 percent of the decedent's gross estate (reduced by debts and expenses); (3) at least 25 percent of the adjusted value of the gross estate must be qualified farm or closely held business real property; [1] (4) the real property qualifying for current use valuation must pass to a qualified heir; [2] (5) such real property must have been owned by the decedent or a member of his family and used or held for use as a farm or closely held business for 5 of the last 8 years prior to the decedent's death; and (6) there must have been material participation in the operation of the farm or closely held business by the decedent or a member of his family in 5 years out of the 8 years immediately preceding the decedent's death (Code secs. 2034A (a) and (b)).[3]

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[1] For purposes of the 50 percent and 25 percent tests, the value of property is determined without regard to its current use value.

[2] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants.

[3] In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for current use valuation includes the farmhouse, or other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or leasee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

*Valuation methods*

The current use value of all qualified real property may be determined under the multiple factor method (Code sec. 2032A(e)(8)). The multiple factor method takes into account factors normally used in the valuation of real estate (for example, comparable sales) and any other factors that fairly value the property.

If there is comparable land from which the average annual gross cash rental may be determined, then farm property may also be valued under the formula method (Code sec. 2032A(e)(7)(A)). Under the formula method, the value of qualified farm property is determined by (1) subtracting the average annual State and local real estate taxes for the comparable land from the average annual gross cash rental for comparable land used for farming, and (2) dividing that amount by the average annual effective interest for all new Federal Land Bank loans.[4]

*Election of special valuation*

The election for special valuation must be made not later than the due date for the estate tax return (Code sec. 2032A(d)(1)). It is to be made in the manner prescribed under Treasury regulations.

*Background*

These provisions were enacted by the Tax Reform Act of 1976 and were effective with respect to estates of decedents dying after December 31, 1976.

In June 1977, the Internal Revenue Service issued a revised estate tax form (Form 706). This form indicated the manner in which the election was to be exercised.

On July 13, 1978, proposed regulations relating to the election were published.

On July 19, 1978, the Department of the Treasury issued proposed regulations describing the circumstances under which current use valuation would be available and defining gross cash rental under section 2032A. Under the proposed regulations, the current use value was to be available only if there were some nonfarm use for the property. The proposed regulations also provide that if no comparable farm property had been leased on a cash basis, then the formula method could be applied by converting crop share rentals into cash rentals. If the crops were sold for cash in a qualified transaction, the selling price would be considered the gross cash rental. If no qualified sale occurred, then the gross cash rental would equal the cash value of the crops on the date received on an established public agricultural commodities market.

On September 10, 1979, the Department of the Treasury withdrew the proposed definition of gross cash rental and published another proposed regulation defining gross cash rental.[5] The new proposed regulation provides that crop share rentals may not be used under the formula method. Consequently, under the proposed regulation, if no comparable land is rented solely for cash, the formula method may not

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[4] Each average annual computation must be made on the basis of the five most recent calendar years before the decedent's death.

[5] 44 Fed. Reg. 52,696 (1979).

be used and the qualified farm property may be valued only by the multiple factor method. The Internal Revenue Service also issued on that date a news release indicating that current use value would be available with respect to any real property which satisfied the requirements of section 2032A, even if there were no other highest and best use for the property.

Final regulations were published July 31, 1980 (Treasury decision 7710).[6]

### *Issue*

The basic issue is whether special transitional rules should be provided to permit special valuation elections to be made after the time prescribed under present law with respect to certain estates.

### *Explanation of the bill*

The bill would provide a special rule for estate tax returns required to be filed before July 13, 1978. Under this special rule, a specal valuation election could be made by an estate required to file before such date no later than the 90th day after the later of (1) the date of enactment of the bill or (2) the earliest date on which all section 2032A necessary regulations become final. In addition, the bill would extend the statute of limitations to allow claims for refund to be made until 90 days after the end of this special election period.

### *Effective date*

Under the bill, the provisions would be effective with respect to estates of decedents dying after December 31, 1976, whose estate tax returns were required to be filed before July 13, 1978 (without regard to extensions of time to file).

### *Revenue effect*

It is estimated that this bill would reduce budget receipts by $15 million in fiscal 1981.

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[6] 45 Fed. Reg. 50736 (1980).

## 8. H.R. 7390—Messrs. Conable, Frenzel and Edwards (of Alabama) and H.R. 7704—Mr. Conable

## Deferred Application of Revenue Procedure 80-5 and Revenue Ruling 80-60 Relating to Inventory Writedowns

### *Present law and background*

*Background*

On February 8, 1980, the Internal Revenue Service issued a news release (Internal Revenue News Release IR-80-19, I.R.B. 1980-6) announcing the publication of Revenue Procedure 80-5 and Revenue Ruling 80-60. Both pronouncements dealt with the Supreme Court decision in *Thor Power Tool Company* v. *Commissioner*, 439 U.S. 522 (1979), and the writedown of excess inventories. The *Thor Power* decision held that a writedown of any item of inventory would be allowed for tax purposes only if it is in accordance with certain procedures set forth in the Treasury regulations. Any other writedowns would not be considered proper and would not be allowed for tax purposes. The IRS pronouncements required full implementation of the *Thor Power* decision for taxpayers with 1979 calendar year-ends.

Thor Power Tool Company manufactured hand held power tools that contained from 50 to 200 parts. The company had a policy of manufacturing all future estimated replacement parts at the same time it manufactured a new product. In this way the company sought to avoid the problem of having to retool at some future date in order to provide replacement parts to its customers. Therefore, the company had more replacement parts on hand than it would need in the immediate future ("excess inventory").

In 1964, Thor Power's new management determined that a large portion of the parts inventory was in excess of any reasonably foreseeable future demand. Therefore, they wrote the inventory down to scrap value for both financial statement purposes and tax purposes. However, the taxpayer did not make any attempt to sell these goods at a reduced price nor to scrap them but instead retained the parts for possible future sale to customers at their original list price.

Under section 471 of the Internal Revenue Code, the taxpayer is required to keep inventories in a manner that conforms as nearly as possible to the best accounting practice in its trade or business and that most clearly reflects its income. Upon audit, the Commissioner conceded that Thor Power's method of accounting for its inventory was in conformity with the best accounting practice in its trade or business because it was standard accounting policy to writedown excess inventories to their net realizable value. However, the Commissioner determined that the writedown did not clearly reflect the taxpayer's income. The Commissioner contended that in order to clearly reflect income for tax purposes the writedown had to conform to the requirements of section 471 regarding market writedowns and that the taxpayer's writedown did not conform to those requirements.

The regulations under section 471 allow a taxpayer to writedown its inventory to the lower value of cost or market. In general, the definition of the market price of a product is the bid price in the market place for such a product. In Thor Power's situation, the replacement parts had not diminished in value with respect to their market price but the taxpayer felt that there were so many of these parts that they would not all be sold. Therefore, its writedown did not reflect a lower market value of the individual parts but reflected the fact that Thor Power would not be able to sell all the parts. Such a writedown does not qualify under the regulations as a tax deductible writedown.

In addition to the market price writedown, the regulations provide for two other circumstances where inventory can be written down below its cost. The first is where the taxpayer actually *offers* the property for sale at prices below the current market price of the inventory during the tax year of the writedown. In that case, the taxpayer may value the inventory at the price being offered less the direct costs of disposition. The second situation is in the case of goods that are not saleable at normal prices because of damage, imperfections, shop ware, and other similar infirmities ("subnormal goods"). In the case of such subnormal goods, the taxpayer may value the inventory at a bona fide selling price less direct costs of disposition. The bona fide selling price is defined as the selling price at which the goods are actually offered for sale during a period ending not later than 30 days after the inventory date (generally the corporation's year-end). In both of these situations, the taxpayer must actually offer the goods for sale.

In *Thor Power*, the taxpayer wrote the inventory down below the market value but did not offer the parts for sale at a reduced price. In fact, the company conceded that it continued to sell these parts at their original list prices. The Supreme Court held that in order for a taxpayer's method of inventory accounting to clearly reflect income, and thus to be an allowable method of inventory accounting under section 471, it must conform to the writedown requirements in the Treasury regulations. Since Thor Power's inventory writedown did not conform to these regulations, it was held to be an improper method of inventory accounting and the deduction for the writedown was denied.

*Rules relating to changes in methods of accounting*

Under Code section 446, a taxpayer may not change the method in which he accounts for his income unless he secures the consent of the Commissioner. This is to prevent taxpayers who account for their income in one manner from changing to another manner and avoiding tax as a result of the change. For instance, if in year one a cash basis taxpayer sells property for $100 on account, income is not recognized until the $100 is actually received in a subsequent year. If in year two, however, the taxpayer changes to an accrual method of accounting, no income will be recognized for that year because under the accrual method of accounting the year for recognizing the $100 of income is the year in which the account receivable arose, which was year one.

In the absence of special rules, this would be the result even though the account receivable is paid in year two because the payment of an account receivable does not give rise to income under the accrual method of accounting. Thus, in this example the taxpayer would avoid entirely the recognition of the $100 of income on the sale.

In order to prevent taxpayers from avoiding tax as a result of changing accounting methods, Code section 446 provides that the taxpayer may not change his method of accounting, even if it is an erroneous method of accounting, without obtaining the permission of the Commissioner. This allows the Commissioner the opportunity to permit the change but only if the taxpayer will make adjustments that will result in the clear reflection of his income. (The amount of the adjustment is actually computed under section 481 and is referred to as the "section 481 adjustment.") However, this provision has the rather anomalous result of requiring a taxpayer to continue an erroneous method of accounting unless he has secured the consent of the Commissioner to change.

With respect to the *Thor Power* decision, the Internal Revenue Service believed that many taxpayers would not request permission to change to the proper method of accounting for excess inventories and, under the requirement that they maintain their method of accounting, they would continue to improperly writedown excess inventories. This not only gave taxpayers the advantage of continuing to write off excess inventories until eventually challenged by the Internal Revenue Service on audit, but it held out the prospect that their erroneous method of inventory accounting might never be discovered by the IRS.

As a response to the possibility that taxpayers would not request permission to change erroneous methods of inventory accounting in accordance with the *Thor Power* decision, the Internal Revenue Service issued Revenue Procedure 80–5 and Revenue Ruling 80–60 on February 8, 1980. Revenue Procedure 80–5 granted blanket permission to all taxpayers that they may change their method of accounting in conformity with the *Thor Power* decision. Revenue Ruling 80–60 presented a fact situation regarding excess inventories and in its conclusion stated that if a taxpayer did not account for its inventory in accordance with the *Thor Power* decision and Revenue Procedure 80–5 that the taxpayer would be filing his tax return "not in accordance with the law." The obvious implication of this last statement is that the taxpayer would be liable for various penalties for failure to file a proper tax return.

*Principal taxpayer argument*

It is the position of taxpayers that the retroactive application of the two IRS pronouncements (i.e., the pronouncements were issued in 1980 but were to actually take effect in 1979) precludes them from being able to comply in 1979 with certain Treasury regulations that would have mitigated the income recapture required under the *Thor Power* decision. The taxpayers claim that if they had proper notice of the pronouncements in 1979 they would have offered a large part of their excess inventory for sale at reduced prices in 1979. Thus, they would have been in compliance with both the Treasury regulations and the *Thor Power* decision on those inventory writedowns and would not have had to recapture income with respect to that inventory. However, since the goods have to be offered for sale in the taxable year in which the writedown is to be taken, taxpayers claim that issuance of the pronouncements in 1980 prevented them from taking any action in 1979.

### *Issue*

The issue is whether the application of Revenue Ruling 80–5 and Revenue Ruling 80–60 should be delayed from 1979 to 1980.

### *Explanation of the bill*

Both bills would delay the effective date of Revenue Procedure 80–5 and Revenue Ruling 80–60 from tax years ending on or after December 25, 1979 to tax years beginning after December 31, 1979. H.R. 7704 contains an additional provision for taxpayers who are prohibited from changing their method of accounting under Revenue Procedure 80–5 because the issue of writedowns for excess inventories has been raised on an IRS examination of their tax return for a prior year. Such taxpayers are required to change their method of accounting for excess inventories in conformity with Revenue Procedure 80–5 only for taxable years beginning after January 16, 1979.

### *Effective date*

The bill would apply to tax years ending after December 31, 1979.

### *Revenue effect*

It is estimated that this bill will reduce budget receipts by about $25 million in fiscal year 1981 and increase them by the same amount in later years, primarily fiscal year 1990.

## 9. H.R. 7504—Mr. Guarini

## Theatrical Production Investment Tax Credit Act of 1980

### *Present law*

Under present law, taxpayers are entitled to receive an investment tax credit for qualified tangible personal property which is placed in service by the taxpayer (Code sec. 38). In order to receive the full credit, the property placed in service by the taxpayer must have a useful life of at least 7 years. If the property has a useful life of at least 5 years (but less than 7 years), the taxpayer is entitled to two-thirds of the full credit. If the property has a useful life of at least 3 years (but less than 5 years), the taxpayer is entitled to one-third of the full credit. In addition, the property will cease to qualify as section 38 property if, during any taxable year, there is any predominant foreign use of the property.

The Tax Reform Act of 1976 provided rules that clarified and modified the application of the investment tax credit to movies and television films. Under these rules, all of the direct United States production costs and, under some circumstances, certain indirect production costs of movies or films qualify for the investment tax credit. The taxpayer may use the actual useful life of the movie or film to determine the amount of the investment credit or may elect an investment tax credit for two-thirds (66⅔ percent) of the full investment tax credit regardless of the useful life of the movie or film. The 1976 Act established detailed rules for allowing the investment credit for all production costs of a film (other than any direct foreign production costs), if at least 80 percent of the film's direct production costs are allocable to the United States. The Act also limited a taxpayer's investment credit to the amount of the taxpayer's capital which is at risk in the film.

No investment tax credit is allowed for the costs of producing a dramatic work before a live audience, such as a play or opera, because a play, opera, or other live presentation is not considered tangible personal property.

### *Issue*

The issue is whether taxpayers should be allowed an investment tax credit for qualified investments in certain theatrical productions.

### *Explanation of the bill*

*In general*

The bill would allow an investment tax credit for qualified investments in theatrical productions. The credit would be based on two-thirds (66⅔ percent) of qualified United States production costs for the presentation of a dramatic work in a commercial theater before a live audience. Works covered by the credit would include plays, musicals, operas and ballets, but would not include presentations primarily for use on television or radio, or in a night club or film. The credit is available only to the extent that the taxpayer has an ownership interest in the theatrical production, i.e., it would be limited to the taxpayer's "at-risk" basis. The rules governing the credit for theatrical productions generally would be similar to the rules in section 48(k) governing the investment credit for movie and television films. However, unlike the rules for films, the bill would not require that the theatrical production be "new" section 38 property.

*Credit base*

"Direct production costs" eligible for the credit would include costs directly associated with the theatrical production, such as equipment, supplies, and compensation for services for actors, production personnel, directors, and producers. Advertising and promotional expenses would not qualify as direct production costs. All direct production costs allocable to the United States (including U.S. Posssessions) would be included in the credit base. In addition, if 80 percent or more of the direct production costs are allocable to the United States, "all other production costs," except for direct costs allocable outside the United States, would be eligible for the credit. Thus, some costs which would not be direct production costs, nevertheless would be included in the credit base for theatrical presentations which are almost entirely U.S.-produced. Under the bill, "all other production costs" would be defined to include a reasonable allocation of general overhead costs, if capitalized; the cost of the rights to present the theatrical production (but not ancillary rights, e.g., television or film rights), if capitalized; contractual labor union residuals; and participations payable as compensation to actors, production personnel, directors, and producers.

The bill would limit the amount of costs for participations for theatrical productions which a taxpayer could include in the credit base during a taxable year. The taxpayer could include the lesser of 25 percent of each participation payable as compensation for services or 12½ percent of the taxpayer's aggregate qualified United States production costs (excluding costs for labor union residuals and participations for services). In computing both the 25 and 12½ percent limits, no more than $1 million in participations may be included for any one individual in a single production.

*Allocation rules*

The bill would establish rules for determining which costs are allocable to the United States and, therefore, eligible for the credit. If the theatrical production is produced partly in the United States and partly abroad, the direct production costs would be required to be allocated between U.S. and foreign production. Compensation for services performed in the United States and for services performed by United States persons, even if performed outside the United States, would be allocable to the United States. Other compensation costs would be allocable to the country where the services are performed. Costs for equipment and supplies would be allocated to the country where their predominant use for the production occurs.

***Effective date***

The effective date of the provisions is not specified in the bill.

***Revenue effect***

It is estimated that the bill would reduce budget receipts by less than $5 million annually.

## 10. H.R. 7556—Messrs. Conable, Rostenkowski, and Seiberling

### Adjustment in Excise Tax on Tires

***Present law***

Present law (sec. 4071(a) of the Code) imposes a manufacturers excise tax of 10 cents per pound on new tires[1] of the type used on highway vehicles, and 5 cents per pound on new nonhighway tires. The tax on new highway tires is scheduled to be reduced to 5 cents per pound on October 1, 1984 (sec. 4071(d)); the tax on nonhighway tires is to remain at 5 cents per pound. Revenues from the tax on tires go into the Highway Trust Fund (through September 30, 1984).

Since these taxes are imposed on the basis of the weight of the tire, the price for which the tire is sold generally does not affect the amount of tax due on a manufacturer's sale. However, under IRS administrative guidelines (Rev. Rul. 59–394, 1959–2 CB 280), an exception occurs when a tire manufacturer sells a new replacement tire at a reduced price pursuant to a warranty or guarantee on the tire that is being replaced. Then the manufacturers excise tax on the replaced tire is to be reduced in proportion to the reduction in price of the replacement tire. This amount is allowable as a credit or refund (without interest) of the manufacturers excise tax on the replaced tire (sec. 6416(b)).

The tire industry's practice has been to apply this rule based on the proportionate reduction in the price to the ultimate consumer where the warranty or guarantee is invoked by the ultimate consumer. This reduction is often greater than the reduction in the price of the replacement tire by the manufacturer to the dealer who provides the replacement tire to the ultimate consumer. However, the Internal Revenue Service has taken the position (Rev. Rul. 76–423, 1976–2 CB 345) that the tax should be reduced in proportion to the reduction in price from the manufacturer to its immediate vendee—usually, a wholesaler or a dealer. Under current warranty or guarantee practices used in the tire industry, the Service's position generally produces a smaller tax reduction (hence, a larger net tax) than that produced by a rule that is based on the adjustment in the sale price to the ultimate consumer.

Revenue Ruling 76–423 also provides similar rules for the situation where the manufacturer's warranty or guarantee runs to the dealer but not to the ultimate consumer, and where the replacement tire is not from the same manufacturer as the original tire being returned under the warranty or guarantee. Finally, the ruling provides that, where the manufacturer initially sells tires to a dealer "under a price reduction arrangement in lieu of a warranty," no adjustment in excise tax is allowable.

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[1] The tax applies on the sale (sec. 4071(a) (1) and (2)) or delivery to a retail outlet (sec. 4071(b)) of a manufacturer, producer or importer. (A lease (sec. 4217) or use (sec. 4218) is treated as a sale for these purposes.) In general, this means that, as to domestically manufactured tires, the tax applies to new tires and also to tires that have been retreaded "from bead to bead" (thereby making them new articles). As to imported tires, the tax applies whether or not the tire is new, if the tire has not previously been taxed in the United States. Tires on imported articles (other than articles taxed under sec. 4061 as trucks, etc.) also are subject to tax.

As originally announced, the 1976 ruling was to have taken effect with respect to this issue on April 1, 1977. After having been twice postponed by the Service, the effective date of the 1976 ruling became April 1, 1978.

### *Issues*

The principal issue is whether the current system of excise taxes on tires should be replaced with a system under which lower tax rates would apply to new tires and no credit or refund would be allowed with respect to tires for which a warranty or guarantee adjustment is made. Such a system could be designed in a manner that would have no significant effect on the overall receipts from the excise taxes on tires.

Another issue is whether, for periods for which credits or refunds are allowed, excise tax credits or refunds should be determined under the tire industry's prior practices or under the rules prescribed in Rev. Rul. 76–423.

### *Explanation of the bill*

The bill would reduce the rate of manufacturers excise tax on new tires by 2.5 percent, beginning on January 1, 1981. Thus, the tax on new highway tires would be reduced to 9.75 cents per pound on January 1, 1981, and to 4.875 cents per pound on October 1, 1984 (when the tax is scheduled to be reduced to 5 cents per pound under present law); and the tax on new nonhighway tires would be reduced to 4.875 cents per pound on January 1, 1981.

The bill also would provide a special rule for the determination of an excise tax credit or refund with respect to tires for which a warranty or guarantee adjustment is made. For the adjustment of any tire after March 31, 1978, and prior to January 1, 1983, a credit or refund would be determined under the practice used by the industry prior to the effective date of Rev. Rul. 76–423. No credit or refund would be allowed for a warranty or guarantee adjustment of any tire after December 31, 1982.

### *Effective date*

The amendments relating to excise tax rates would apply for new tires sold after December 31, 1980.

The provisions relating to the determination of an excise tax credit or refund would apply to the adjustment of any tire after March 31, 1978, and prior to January 1, 1983.

The amendments relating to disallowance of an excise tax credit or refund would apply to the adjustment of any tire after December 31, 1982.

### *Revenue effect*

Because it would reduce excise tax rates on new tires for two years before it would first disallow credits or refunds, it is estimated that the bill would decrease net excise tax receipts (receipts less credits and refunds) by $15 million in fiscal year 1981, by $20 million in fiscal year 1982, and by $5 million in fiscal year 1983. The bill would have negligible effects on net receipts after fiscal year 1983. (The receipts otherwise would go into the Highway Trust Fund—through September 30, 1984.)

## 11. H.R. 7618—Messrs. Corman, Shannon and Smith (Iowa)

## Incentive Stock Options

### *Present law*

Under present law, the taxation of stock options granted by an employer to an employee as compensation is governed by the rules of section 83 of the Internal Revenue Code. Generally, under section 83, the value of the option constitutes ordinary income to the employee if the option itself has a readily ascertainable fair market value at the time it is granted to the employee. If the option does not have a readily ascertainable value when granted, it does not constitute ordinary income at the time granted; when the option is exercised, however, the spread between the option price and the value of the stock at that time constitutes ordinary income to the employee. Personal service income is generally taxed at a maximum rate of 50 percent.

In addition, the employer generally is allowed a business expense deduction in the amount includible in the employee's income in its corresponding taxable year (Code sec. 83(h)).

### *Background of tax treatment of stock options*

*Restricted stock options*

The Revenue Act of 1950 added provisions for the use of a "restricted stock option" under which no income tax was imposed either when the option was granted or exercised. Instead, tax generally was imposed at the time the stock involved was sold by the employee. In the case of those restricted stock options where the option price was at least 95 percent of the market price of the stock at the time the option was granted, the entire amount of any gain realized by the employee at the time he sold the stock was treated as capital gain. Where the stock option price was between 85 and 95 percent of the market price at the time the option was granted, the difference between the option price and the market value of stock at the time of the grant of the option was treated as ordinary income when the stock was sold. Any additional gain at the time the stock was sold in such cases was treated as capital gain. In the case of these restricted stock options, employers were not allowed any deduction for the amount of the gain realized by the employee, whether this gain was treated as capital gain or ordinary income.

For a stock option to be classified as a restricted stock option and be eligible for the treatment outlined above, the option price must have been at least 85 percent of the market price of the stock at the time the option was granted; the stock and/or the option must have been held by the employee for at least 2 years after the date of the granting of the option and the stock held for at least 6 months after it was transferred to him; the option must not have been transferable other than at death; the individual may not have been a 10-percent shareholder in the corporation (unless the option price was at least 110 percent of the fair market value); and the option must not have been for a period of more than 10 years.

*Qualified stock options*

The Revenue Act of 1964 repealed the restricted stock option provisions and added provisions allowing so-called "qualified stock options".

These qualified stock options were taxed in a manner similar to restricted stock options. These options, however, must have been granted with an option price of at least the market price when the option was granted (subject to a 150-percent tax where a good faith attempt to meet this requirement failed).

In addition, qualified stock options were subject to the additional rules that the stock must be held 3 years or more; the option may not have been held more than 5 years; stockholders' approval must have been obtained: the options must have been exercised in the order granted; and no option may have been granted to shareholders owning more than 5 percent of the stock (increased up to 10 percent for corporations with less than $2,000,000 equity capital).

*1969 Tax Reform Act—Minimum tax and maximum tax*

The Tax Reform Act of 1969 added a minimum tax under which a tax was imposed equal to 10 percent of the items of tax preference (reduced by a $30,000 exemption plus regular tax liability). Both the bargain element on restricted and qualified stock options and the excluded portion portion of capital gains were items of tax preference.

In addition, a 50-percent maximum marginal tax rate on income from personal services was added. However, the income eligible for this rate was reduced generally by the sum of the items of tax preference in excess of $30,000.

*1976 Tax Reform Act—Repeal of qualified stock options, etc.*

The Tax Reform Act of 1976 repealed qualified stock option treatment for options granted after May 20, 1976, (except for certain transitional options which will cease to be qualified after May 20, 1981). This Act also increased the minimum tax rate to 15 percent, reduced the exemptions for the minimum and maximum tax and permitted deferred compensation to qualify for the 50-percent maximum rate on personal service income.

*Revenue Act of 1978*

The Revenue Act of 1978 removed the excluded portion of capital gains from the minimum and maximum tax and made it subject to a new alternative minimum tax. In addition, the taxes on capital gains were reduced so that the maximum rate of tax on these gains is 28 percent.

***Issue***

The issue is generally whether Congress should reinstitute a stock option provision under which an employee may be granted an option to buy his employer's stock and be taxed at capital gains rates at the time he or she sells the stock.

### *Explanation of the bill*

The bill would create an "incentive stock option", which would be subject to taxation in a manner similar to the tax treatment previously available to restricted and qualified stock options—i.e., there would be no tax consequences at the time the option is exercised, and the employee would be eligible for capital gain treatment when the stock is sold.

For an option to qualify as an "incentive stock option"; (1) the exercise price must be not less than fair market value of the stock at the time the option is granted (in the case of a variable option, determined as if the option had been exercised when granted); (2) the option must be exercised within 10 years of the date granted; (3) shareholder approval is required; (4) the individual may not be an employee owning more than 10 percent of the value or voting power of stock of the company (unless the option price is at least 110 percent of the stock's fair market value); (5) the optionee must be an employee continuously from grant of the option to 3 months prior to exercise; (6) the option may be transferred only at death; and (7) the stock must be held for at least 2 years after the date of the granting of the option and for at least one year after the option is exercised.

### *Effective date*

The provisions of the bill would apply to options granted after the date of enactment of the bill.

### *Revenue effect*

This bill will reduce budget receipts by less than $5 million in fiscal years 1981–1984 and increase budget receipts by $15 million in fiscal year 1985.

## 12. H.R. 7766—Messrs. Corman and McKinney

### One-Year Extension of Fuels Tax Exemption for Certain Taxicabs

#### *Present law*

Under present law (enacted in the Highway Revenue Act of 1978), certain taxicab use of motor fuels is exempt (through refund or credit) from the 4 cents a gallon excise tax on gasoline and other motor fuels. The fuel is exempt if (1) taxicabs are not prohibited from ride sharing (under company policy or the rules of a Federal, State or local authority having jurisdiction and (2) for 1978 and later model cabs acquired after 1978, the fuel economy of the model type of vehicle must exceed the fleet average fuel economy standard applicable under the Motor Vehicle Information and Cost Savings Act, as amended. However, the requirement does not apply to vehicles manufactured by certain small manufacturers (that is, those that produce less than 10,000 vehicles per year and which have been granted an exemption under section 502(c) of that Act).

A purchaser who uses the fuel for qualified taxicab services may file for a refund for the first three quarters of his taxable year if the refund of tax due is $50 or more as of the end of a quarter. Any amounts not otherwise refunded may be claimed as a credit on the purchaser's tax return.

The exemption applies for calendar years 1979 and 1980. Under the conference report for Highway Revenue Act of 1978, a Treasury report is to be submitted concerning the impact of the exemption.

#### *Explanation of the bill*

The bill would extend the present fuels tax exemption for qualified taxicab services for one year, or through December 31, 1981.

#### *Effective date*

The bill applies to fuels used after December 31, 1980, and before January 1, 1982.

#### *Revenue effect*

It is estimated that this bill would reduce budget receipts by $10 million in fiscal year 1981, $20 million in fiscal year 1982, and by a negligible amount thereafter. These receipts would otherwise remain in the Highway Trust Fund.

### 13. H.R. 8058—Mesrs. Stark, Corman and Rousselot

### Accrual of Tax Deductions After Change in Liability Date

***Present law***

Under the accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount of the deduction can be determined with reasonable accuracy. However, present law also provides that if a taxing jurisdiction changes the time for imposing a deductible tax so that the tax would be deductible in an earlier period under the above rule, nevertheless an accrual basis taxpayer may not deduct the tax in the earlier period. Instead, the taxpayer may deduct the tax in the period that the tax would have otherwise been deductable if the taxing jurisdiction had not changed the time for imposing the tax.

This provision was enacted to prevent taxpayers from getting two tax deductions in one year because the taxing jurisdiction accelerated the assessment date of a tax. Thus, if a property tax lien date was January 1, of each year and for 1980 the local tax jurisdiction changed the lien date for 1981 and all years thereafter to December 31, the taxpayer would get two tax deductions in 1980—one for the January 1, 1980 lien which was not changed and one for the December 31, 1980 lien date which was changed from January 1, 1981. In this situation, present law would require that an accrual basis taxpayer ignore the change of lien dates and accrue a deduction in accordance with the law before the change, i.e., January 1, 1981.

***Explanation of the bill***

The bill would allow a taxpayer to elect to accrue a deduction for taxes where the liability date of the tax (i.e., the date the tax is accrued under Federal income tax accounting principles) has been changed to an earlier date ("postchange tax") by the appropriate tax jurisdiction. However, the bill still eliminates the possibility of two tax deductions in the year of change by not allowing the taxpayer to deduct the tax that accrues in the year of change (or, if greater, the tax in one of the two preceding taxable years (see discussion below) under the law of the taxing jurisdiction before the change in the liability date ("pre-change tax"). For example, in the illustration in *present law*, the taxpayer would be allowed to deduct the tax having the lien date of December 31, 1980 and would not be allowed to deduct the tax with the lien date of January 1, 1980.

The denial of the deduction for the pre-change tax is accomplished through a suspense account. A suspense account is an account that records the expenditure for the tax but not in an expense account. Under the bill the greater of the pre-change tax or the tax accrued in the two preceding years is placed in a suspense account. If the pre-change tax is the greater tax and is thus entered in the suspense account it results in a denial of a deduction for that tax. If the tax in one of the two preceding taxable years is the greater tax and is thus entered in the suspense account, it results in a denial of a deduction to the extent of the pre-change tax and in an inclusion in income of the excess of the greater tax over the pre-change tax in order to offset the deduction of the greater tax in the earlier year.

The bill also provides that the suspense account will be reduced if the tax deduction in any of the post-change years is less than the amount in the suspense account. The effect of this reduction will be to allow a deduction for the amount of the reduction. (If the tax under consideration is an income tax, then the reduction in the suspense account, and the resulting deduction, is calculated using the greater of the tax deduction for the current year or the deduction for either of the two preceding years.) However, if the amount of any subsequent tax liability exceeds the amount of the suspense account the amount of that excess will be added to the suspense account until the amount in the suspense account equals the amount originally entered in the suspense account. The amount of the addition to the suspense account is treated as income for that year.

The bill also provides that if a taxpayer has never been liable for a pre-change tax in the taxing jurisdiction but has only been liable for post-change taxes, then the taxpayer will not have to establish a suspense account but will accrue the post-change tax on the new liability date. This would occur in a situation where a corporation is organized after the liability date of a tax is changed so that as far as it is concerned there is no chance that it could accrue two tax deductions in one year.

The election under this bill can be made for any taxable year if made within the time period prescribed for filing the tax return for that year (including extensions). Although the manner of making the election is to be prescribed by the Secretary in regulations, the election does not have to be made with the consent of the Secretary. The election will be binding for the taxable year in which it is made and for all subsequent taxable years unless the taxpayer secures the consent of the Secretary to revoke the election.

The bill also directs the Secretary to prescribe regulations which treats taxes that are enacted as a substitute for a substantially similar tax as the same tax. Also, nonrecognition transactions under Subchapter C of the Code are to be dealt with in regulations.

### *Effective date*

The bill would apply only to the actions of taxing jurisdictions taken after the date of enactment of this bill. However, if the taxpayer makes an election within his first or second taxable year after the bill's date of enactment with respect to an income tax (or a franchise tax based on income) which the taxpayer first became subject to after the change of the liability date and he has consistently accrued the tax deduction on the new liability date, then the taxpayer could elect to continue accruing the tax deduction on the new liability date. Also, the taxpayer does not have to establish a suspense account. Essentially, this election allows taxpayers who were never subject to the pre-change tax, and thus would not have gotten two tax deductions in one year, to continue to deduct the tax on the new liability date. Thus, in this case the effective date of the bill would be retroactive to the date the taxpayer first became liable to the post-change tax.

### *Revenue effect*

The revenue estimate for this bill is not yet available.

## 14. H.R. 8073—Mr. Ullman

### Tax Treatment of Certain Transactions Involving Automobiles and Trucks

#### *Present law*

Under present law, an automobile or truck used in a trade or business or for the production of income is depreciable property and is eligible for the regular investment credit (as reduced by rules which apply to an asset having a useful life of less than seven years). Generally, any depreciation deduction or investment credit allowable in a taxable year for a leased auto or truck is claimed by the lessor.

It is understood that "lease agreements" in the motor vehicle industry frequently contain a "rental adjustment clause." This clause provides that upon termination of the lease the vehicle will be sold by the lessor (with no option by the lessee to purchase). If the proceeds from sale are less than the residual value specified in the agreement, the lessee is required to pay the difference to the lessor; but if the proceeds exceed the residual value, the lessor is required to pay such excess to the lessee.

In a National Office Technical Advice Memorandum (8019120) dated December 20, 1979 the Internal Revenue Service took the position that the risk of ownership shifts to the user when the agreement contains a rental adjustment clause and, therefore, that for the tax purposes the transaction is a conditional sale rather than a lease. Under the Service's position, the taxpayer contractually designated as the "lessee," not the "lessor," is allowed to claim any depreciation deduction or investment credit for qualifying uses an automobile or truck so transacted. The Service did not exercise its discretionary power (under Code sec. 7805(b)) to apply its position without retroactive effect.

#### *Issue*

The issue is whether an agreement, under which a person acquires from another person the right to use an automobile or truck for a specified period and which contains a rental adjustment clause, constitutes a lease or a sale for Federal income tax purposes if the agreement is entered into before January 1, 1981.

#### *Explanation of the bill*

The bill provides that the determination of whether a transaction is a sale or lease for Federal income tax purposes would be made without regard to any rental adjustment clause in the agreement, where such transaction is entered into before January 1, 1981, and under which a person acquires from another person the right to use an automobile or truck for a specified period.

#### *Effective date*

The bill would apply to transactions entered into before January 1, 1981.

#### *Revenue effect*

The revenue estimate for this bill is not yet available.